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Supreme Court, U.S.
FILED
DEC 19 1996
CLERK

No. 96-714

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

WEYERHAEUSER COMPANY AND SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR THE UNITED STATES

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12pp

TABLE OF AUTHORITIES

Cases: Page

Harper v. *United States*, 396 F.2d 223 (4th Cir. 1968) 1, 2

Kirby Lumber Corp. v. *Scofield*, 89 F. Supp. 102 (W.D. Tex. 1950) 6

Lebron v. *National R.R. Passenger Corp.*, 115 S. Ct. 961 (1995) 5

Rosenthal v. *Commissioner*, 416 F.2d 491 (2d Cir. 1969) 1, 2, 3, 4, 7, 10

Scott v. *United States*, 305 F.2d 460 (Ct. Cl. 1962) 6

United States v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989) 7

United States v. *Hill*, 506 U.S. 546 (1993) 7

United States v. *Williams*, 504 U.S. 36 (1992) 5

Westvaco Corp. v. *United States*, 639 F.2d 700 (Ct. Cl. 1980) 1, 2, 3

Yee v. *City of Escondido*, 503 U.S. 519 (1992) 5

Statute, regulations and rule:

26 U.S.C. 165(b) 10

26 C.F.R.:

Section 1.61-6(a) 1, 6, 9

Section 1.165-7(b)(2)(i) 3, 4

Section 1.612-1(a) 1, 6, 10

Sup. Ct. R. 10(a) 8

REPLY BRIEF FOR THE UNITED STATES

Respondents do not dispute (Br. in Opp. 7, 16-18) that the decision of the Federal Circuit in this case—which relies solely upon the prior decision of that circuit in *Westvaco Corp.* v. *United States,* 639 F.2d 700 (Ct. Cl. 1980)—conflicts with the decision of the Second Circuit in *Rosenthal* v. *Commissioner,* 416 F.2d 491 (1969), and the decision of the Fourth Circuit in *Harper* v. *United States,* 396 F.2d 223 (1968). Respondents nonetheless contend that review by this Court is unnecessary because (i) the government advanced an alternative argument in this case that did not rely on the exact rationale of the decisions in *Rosenthal* and *Harper,* (ii) the conflict among the circuits is unimportant because "no taxpayer is ever going to litigate this issue outside the Federal Circuit" (Br. in Opp. 16) and (iii) the issue lacks substantial fiscal importance. None of these rationales withstands scrutiny.

1. a. As we explain in the petition, there are two available methods for apportioning the basis of a timber property when a portion of the property is sold or damaged by a casualty. The basis may be allocated either under the apportionment method applicable to sales of cut timber (the board-foot method) or under the method applicable to sales of tracts of standing timber (the historical cost method). See Pet. 2-5. These alternative allocation methods are particularized applications of the general rule that, "[w]hen a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts." 26 C.F.R. 1.61-6(a). See also 26 C.F.R. 1.612-1(a) (when "a part" of the uncut timber within a "depletion block" is sold, the aggregated basis of the depletion block "shall be allocated to the part sold and the part retained").

In *Rosenthal* and *Harper,* the government successfully contended that the apportionment method applicable to

sales of *cut* timber applies in cases involving the casualty loss deduction and that the aggregated basis of the depletion block is therefore to be allocated to the destroyed timber on a board-foot basis. *Rosenthal* v. *Commissioner*, 416 F.2d at 497; *Harper* v. *United States*, 396 F.2d at 223. In *Westvaco Corp.* v. *Commissioner*, 639 F.2d at 708-709, however, the predecessor of the Federal Circuit rejected the reasoning and conclusion of *Rosenthal* and *Harper*. The court held in *Westvaco* that the board-foot method is inapplicable in determining the basis recoverable upon a casualty to timber because not all casualty losses result in the destruction of board-feet of marketable timber. *Id. at* 705, 712, 718. See Pet. 7 n.4.

In the present case, the government was, of course, aware that the Federal Circuit had rejected the board-foot method of apportioning basis for a partial destruction of timber property in *Westvaco* and therefore argued for application of the alternative allocation method applicable for sales of standing, uncut timber. The government took the position that the basis to be recovered for damage to an identifiable stand of timber may be determined by apportioning to that stand of timber—from the total aggregated basis of the timber block owned by the taxpayer—the historical costs allocable to that tract. The trial court agreed with the government's allocation method, but the Federal Circuit reversed. The court of appeals held that its decision in *Westvaco* prevented *any* apportionment of the aggregated basis of the "depletion block" to the particular portion of the property that was damaged or destroyed by the casualty (Pet. App. 8a). The court held, instead, that the entire basis of the "depletion block" may be recovered as a casualty loss even though only a small portion of the timber located in that block had in fact been damaged or destroyed by the casualty (*ibid.*). See Pet. 16.

In so holding, the decision of the Federal Circuit conflicts directly with *Rosenthal* and *Harper* and, in particular, with the interpretation by those circuits of the

applicable regulations. The Federal Circuit held in this case that the "single, identifiable property damaged or destroyed"—the basis of which limits the casualty loss deduction under 26 C.F.R. 1.165-7(b)(2)(i)—is, as a matter of law, the entire "depletion block" that the taxpayer uses for management and accounting purposes (Pet. App. 8a). The court specifically rejected the view that it is the basis attributable to the "identifiable" stands of timber actually "damaged or destroyed" by the casualty event that limits the loss (*ibid.*). In *Rosenthal*, by contrast, the Second Circuit held, under this same regulation, that only the basis attributable to the particular timber "damaged or destroyed" by the casualty event may be recovered as a loss deduction. 416 F.2d at 498-500. See Pet. 14-16. The court in *Rosenthal* required the taxpayer to "ratably allocate" the aggregated basis of the depletion block to the specific timber in fact damaged in computing the casualty loss (416 F.2d at 500).

The decision of the Federal Circuit in this case thus makes clear what was uncertain after *Westvaco*. In *Westvaco*, the court had suggested that the proper definition of the damaged property was a factual issue (Pet. App. 81a, quoting 639 F.2d at 720). That decision thus left open the possibility that some method might be derived for reconciling the ostensibly fact-based holding of *Westvaco* with the apportionment rationale of *Rosenthal* and *Harper*. Indeed, the trial court in this case relied precisely on that understanding of *Westvaco* in concluding, as a factual matter, that the "stand" is the relevant "property damaged or destroyed" that limits the casualty loss deduction under the regulation (Pet. App. 81a-83a, 118a-119a).

The Federal Circuit held on appeal, however, that, "as a matter of law," no allocation of the basis of the timber block between the damaged and undamaged portion is required in calculating the loss deduction from a casualty event (Pet. App. 8a). By refusing to limit the casualty loss deduction to "that portion of the basis in the tract ratably allocable to such specific [damaged] timber"

(*Rosenthal* v. *Commissioner*, 416 F.2d at 497-498), the decision in this case thus establishes an irreconcilable conflict among the circuits on an issue of substantial recurring importance.

b. The principal contention of respondents in opposing certiorari is that the government did not rely in this case on the "board-foot" allocation method (for sales of cut timber) applied in *Rosenthal* and *Harper* but instead advanced the alternative, "historical cost" rationale (for sales of standing timber) adopted by the Court of Federal Claims. Respondents argue that (i) the rejection of the "historical cost" rationale in this case creates no conflict with *Rosenthal* and *Harper* and, (ii) even if it does, the government did not rely on those decisions in this case.

The holding of the Federal Circuit that, as a matter of law, a timber company may deduct its entire basis in the depletion block even though only part of the timber in that block was "damaged or destroyed" (26 C.F.R. 1.165-7(b)(2)(i)) conflicts with the express holding of *Rosenthal* that the casualty loss deduction is limited to "that portion of the basis in the tract ratably allocable to such specific [damaged] timber." 416 F.2d at 497. In particular, the decision of the Federal Circuit in this case conflicts directly with the holding of *Rosenthal* that, under the regulation that limits the casualty loss deduction to the basis of the "single, identifiable property damaged or destroyed" (26 C.F.R. 1.165-7(b)(2)(i)), the casualty loss deduction is limited to the basis allocable to the "specific timber" that was actually damaged or destroyed as if "a partial sale of such timber" had occurred. 416 F.2d at 498.

Respondents nonetheless contend that review is inappropriate because, "absent exceptional circumstances, [the Court] will not consider arguments that were not presented to the court of appeals" (Br. in Opp. 13). To the contrary, this Court's "traditional rule is that '[o]nce a federal claim is properly presented, a party can make any argument in support of that claim; parties are not

limited to the precise arguments they made below.'" *Lebron* v. *National R.R. Passenger Corp.*, 115 S. Ct. 961, 965 (1995), quoting *Yee* v. *City of Escondido*, 503 U.S. 519, 534 (1992). Here, the issue of the proper allocation of the basis of timber property in calculating a casualty loss deduction was unquestionably and directly presented to the court of appeals in this case. And, if respondents are claiming that, in further litigation in the Federal Circuit after *Westvaco*, it was necessary for the government to continue challenging that decision in order to "preserve" that issue for this Court's review, respondents are simply wrong. This Court has squarely held that there is no requirement "that a party demand overruling of a squarely applicable, recent circuit precedent" when "that precedent was established in a case to which the party itself was privy and over the party's vigorous objection." *United States* v. *Williams*, 504 U.S. 36, 44 (1992). As the Court has held, a litigant need not act in defiance of applicable circuit precedent to obtain review of that precedent in subsequent litigation (*id.* at 44-45) (footnote omitted):

> It is a permissible exercise of our discretion to undertake review of an important issue expressly decided by a federal court where, although the petitioner did not contest the issue in the case immediately at hand, it did so as a party to the recent proceeding upon which the lower courts relied for their resolution of the issue, and did not concede in the current case the correctness of that precedent.

Of course, in the present case, the government *did* "contest the issue" of the proper allocation of basis in casualty losses involving timber. Under this Court's holding in *Williams*, the government's effort to reconcile *Westvaco* with ordinary tax principles—by arguing for an alternative (but conceptually consistent) method of allocation from the method adopted in *Rosenthal*—does not bar the government from seeking review in this Court of the

conflict among the circuits on this important, recurring issue.

c. Respondents err in contending (Br. in Opp. 14-15) that adoption of the government's position would require alteration of the judgment entered in the trial court. The trial court entered judgment in the government's favor based upon the "historical cost" method of allocating basis among the damaged and undamaged portions of the timber property and held that the basis attributable to stands of timber that were *not* damaged or destroyed is not relevant in determining the casualty loss deduction (Pet. App. 77a, 168a). The government contended, and the trial court agreed, that this is one of the alternative methods by which the basis of timber may be "equitably apportioned" (26 C.F.R. 1.61-6(a)) and allocated between "the part [damaged] and the part retained" (26 C.F.R. 1.612-1(a)). See Pet. 2-5.[1] Our submission to this Court would not require alteration of that judgment.

By contrast, what the taxpayer may not do (but what the Federal Circuit approved in this case) is deduct the entire basis of a depletion block when only a part of the

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[1] Without any foundation or supporting citations, respondents assert that "the historical cost of the portion of the timber sold" (Br. in Opp. 5 n.1) is not a valid alternative method for calculating the basis for the sale of a tract of standing timber. But respondents do not dispute that, in determining the basis for the sale of "a part" of a timber property, the basis of the depletion block is to be allocated between "the part sold and the part retained" (26 C.F.R. 1.612-1(a)). See, *e.g.*, *Scott* v. *United States*, 305 F.2d 460, 461 (Ct. Cl. 1962) (historical costs used to determine basis upon sale of standing timber tract to third party); *Kirby Lumber Corp.* v. *Scofield*, 89 F. Supp. 102, 103 (W.D. Tex. 1950) (same); Pet. 4-5. Instead, respondents merely assert that, in applying the historical cost method of basis allocation, various types of historical expenses attributable to a specific tract must be taken into account in determining the "adjusted" basis of that tract (Br. in Opp. 5-6 n.1). Nothing in the government's submission in this case is inconsistent with that proposition. Indeed, the judgment entered in the government's favor by the Court of Federal Claims in this case is based precisely on such "adjusted" calculations of basis. See Pet. App. 168a.

timber in that area was in fact damaged or destroyed. See Pet. 11-16. As the Second Circuit held in *Rosenthal*, "it is quite obvious" that only the "portion of the basis in the tract ratably allocable to such specific [damaged] timber" may be deducted. 416 F.2d at 496-497. Otherwise, the taxpayer would be permitted to "borrow basis from his unharmed property in order to increase the amount of his loss deduction for an injury to his other property." *Id.* at 498.

2. Respondents suggest that this conflict among the circuits is unimportant because, in the future, "no taxpayer is ever going to litigate this issue outside the Federal Circuit" (Br. in Opp. 16). As respondents emphasize, taxpayers—having lost this issue in two circuits—have now prevailed in the one circuit that has a nationwide jurisdiction for tax refund claims. As a result, respondents suggest that all future litigation will be directed by taxpayers into that one circuit and that the existing conflict among the courts of appeals is therefore "merely academic" and "of historical interest only" (*id.* at 17, 18).

That contention errs for two reasons. First, the fact that any taxpayer may bring a refund suit in the Federal Circuit does not mean that the Internal Revenue Service may ignore the law of other circuits in auditing and determining tax liabilities.[2] Moreover, respondents miss entirely the point of cases such as *United States* v. *Hill*, 506 U.S. 546 (1993), and *United States* v. *Goodyear Tire & Rubber Co.*, 493 U.S. 132 (1989), in which this Court reviewed decisions of the Federal Circuit *in the absence of a conflict*. The point of this Court's decisions in those

[2] For example, in auditing and determining the liability of a taxpayer domiciled in the Second Circuit, the Service would be expected to apply the rule of *Rosenthal* and to enforce that rule, if necessary, through administrative assessments and collection. The Service cannot ignore the existing conflict because many taxpayers —due to bankruptcy or other reasons—fail to pay assessments. Collection actions therefore must be commenced against them in the circuit in which they reside.

cases is that, once the Federal Circuit has entered a decision favorable to taxpayers on an important, recurring question of federal law, the possibility of a conflict *thereafter* being established is remote because all taxpayers *thereafter* may seek to litigate the issue only in the Federal Circuit. When the realities of forum shopping make it unlikely that a conflict will thereafter arise, this Court has undertaken to review such decisions even in the absence of a conflict.

But, when (as in the present case) a conflict exists among the circuits *at the time* of the Federal Circuit decision, there is no need to speculate about whether a conflict will thereafter arise. The fact that the Federal Circuit has entered a decision that conflicts with the rule of other circuits is itself a sufficient reason for this Court's review. Sup. Ct. R. 10(a). In this context, the fact that the Federal Circuit has a nationwide jurisdiction is merely an *additional* reason justifying review—for it is unquestionably the function of this Court, not of the Federal Circuit, authoritatively to resolve conflicts among the circuits on recurring, important questions of federal law.

3. Respondents claim that the question presented in this case lacks sufficient fiscal importance to justify this Court's review. Respondents suggest that "for the [timber] industry as a whole this issue involves only $20-$25 million per year" (Br. in Opp. 19). Even though such a fiscal impact from a recurring legal issue would, in our view, be sufficient to merit this Court's review of the conflict among the circuits, it is evident that respondents' estimate of the amounts involved is understated.

Respondents acknowledge that their estimate is derived simply by extrapolating for the timber industry as a whole the loss rates incurred by respondents for a particular set of years (Br. in Opp. 19). There is no basis, however, for any contention that respondents' losses for a particular four-year period are representative of the recurring losses incurred by other timber producers. The "sample" from which respondents extrapolate to the "universe" is too

narrow to be useful. The Internal Revenue Service has performed an analysis of the tax consequences of the casualty loss issue addressed in this case for the industry as a whole over a ten-year period. Based upon this analysis, the Service has concluded that the taxes affected by this issue for the industry as a whole exceed $100 million per year.

The recurring importance of the proper application of the casualty loss deduction for the timber industry is emphasized by the fact that such claims occur each year and that numerous tax audits and examinations are pending in which this issue is presented. This Court's resolution of the important, recurring question presented in this case is needed to avoid repetitive and wasteful litigation and to ensure that the generally applicable, fundamental tax principles that apply in this context are not distorted for the advantage of a particular segment of industry.

4. Respondents contend that the decision of the court of appeals does not "deviate[] from settled tax law principles" (Br. in Opp. 23). In making that assertion, however, respondents do not dispute that "settled tax law principles" require that, when part of a property is sold or damaged, "the cost or other basis of the entire property shall be equitably apportioned among the several parts." 26 C.F.R. 1.61-6(a). Instead, respondents contend that something about the timber industry makes it different. They assert (Br. in Opp. 28-29) that the regulations that permit a taxpayer to aggregate basis for the "depletion block" erect an obstacle to any equitable apportionment of that basis when only part of the depletion block is damaged or destroyed by a casualty. That contention, however, was squarely and correctly rejected by the Second and Fourth Circuits in *Rosenthal* and *Harper*. See Pet. 14-16. Indeed, the very function of a "depletion block" is to serve as a temporary repository of basis that is to be equitably allocated to the timber *as it is cut and sold* (see Pet. 3-4 & n.1) or *as it is sold as standing timber* (see Pet. 4-5). Even respondents acknowledge, as they

must, that, "[w]hen timber is sold, the adjusted basis used to calculate gain or loss is * * * derived by allocating a portion of the total adjusted basis in the [depletion] block to the portion of the block that is sold. [26 C.F.R.] 1.612-1(a)." Br. in Opp. 5. Because the casualty loss deduction is limited by the basis that would be recovered if the damaged property were sold (26 U.S.C. 165(b)), the deduction available for a casualty to timber must be limited to the basis that would have been recovered if the damaged timber had been sold.

As the courts correctly held in *Rosenthal* and *Harper*, the deduction for a casualty loss may *not* include the basis of timber that was *not* damaged by the casualty, for "[a] taxpayer may not borrow basis from his unharmed property in order to increase the amount of his loss deduction for an injury to his other property." 416 F.2d at 497-498. It is a fundamental misapplication of tax principles to *refuse* to allocate basis between "the part [damaged] and the part retained" (26 C.F.R. 1.612-1(a)), as the Federal Circuit did in this case. See Pet. 14-16.

For the reasons stated above and in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

DECEMBER 1996

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